

Financial statements and report of independent certified public accountants

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

June 30, 2005 and 2004

December 14, 2005

Board of Trustees
Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

Dear Ladies and Gentlemen:

This is our report on the financial audits of the Hawaii Employer – Union Health Benefits Trust Fund of the State of Hawaii (Trust Fund) for the years ended June 30, 2005 and 2004. Our audits were performed in accordance with the terms of our contract with the State of Hawaii.

OBJECTIVES OF THE AUDIT

The primary purpose of our audits was to form an opinion on the fairness of the presentation of the Trust Fund's basic financial statements for the years ended June 30, 2005 and 2004. More specifically, the objectives of the audits were as follows:

1. To provide a basis for an opinion on the fairness of the presentation of the basic financial statements of the Trust Fund.
2. To determine whether expenditures and other disbursements have been made and all revenues and other receipts to which the Trust Fund is entitled have been collected and accounted for in accordance with the laws, rules and regulations, and policies and procedures of the State of Hawaii.
3. To determine whether the Trust Fund has complied with the laws and regulations that may have a material effect on the basic financial statements.

SCOPE OF THE AUDIT

Our audits were performed in accordance with auditing standards generally accepted in the United States of America as prescribed by the American Institute of Certified Public Accountants and *Government Auditing Standards*, issued by the Comptroller General of the United States. The scope of our audits included an examination of the transactions and accounting records of the Trust Fund for the years ended June 30, 2005 and 2004.

Board of Trustees
Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii
December 14, 2005

ORGANIZATION OF THE REPORT

This report is presented in two parts as follows:

- Part I – The financial statements and related notes of the Trust Fund for the years ended June 30, 2005 and 2004 including our opinion on the basic financial statements.
- Part II – Our report on internal control over financial reporting and on compliance and other matters.

We wish to express our sincere appreciation for the excellent cooperation and assistance extended by the officers and staff of the Trust Fund.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Grant Shantre".

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PART I
FINANCIAL SECTION

Report of Independent Certified Public Accountants

Board of Trustees
Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

We have audited the accompanying statements of net assets – enterprise fund of the Hawaii Employer – Union Health Benefit Trust Fund of the State of Hawaii (Trust Fund) as of June 30, 2005 and 2004, and the related statements of revenues, expenses and changes in net assets – enterprise fund, and cash flows – enterprise fund for the years then ended. These financial statements are the responsibility of the management of the Trust Fund. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Trust Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note A, the financial statements of the Trust Fund are intended to present the financial position, and the changes in financial position and cash flows, of only that portion of the business-type activities of the State of Hawaii that is attributable to the transactions of the Trust Fund. They do not purport to, and do not, present fairly the financial position of the State of Hawaii as of June 30, 2005 and 2004, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Trust Fund as of June 30, 2005 and 2004, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated October 28, 2005 on our consideration of the Trust Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that

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testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

The Management's Discussion and Analysis on pages 8 through 10 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

A handwritten signature in black ink, appearing to read "Grant Thornton LLP", is positioned to the right of the date.

Honolulu, Hawaii
October 28, 2005

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2005 and 2004

This section of the Hawaii Employer – Union Health Benefits Trust Fund of the State of Hawaii (Trust Fund) financial report presents the reader with an introduction and overview of the Trust Fund's financial performance for the years ended June 30, 2005 and 2004. This discussion has been prepared by management and should be read in connection with the financial statements, and the notes thereto, which follow this section.

In 2001, the State Legislature enacted Act 88 to amend the Hawaii Revised Statutes (HRS) by adding Chapter 87A that established the Trust Fund. The Trust Fund is the state agency that provides eligible State and County employees and retirees and their eligible dependents with health and life insurance benefits at a cost affordable to both the public employers and participants. The Trust Fund replaced the Hawaii Public Employees Health Fund (Health Fund), effective July 1, 2003. As a result, the Health Fund ceased operations and HRS Chapter 87 was repealed effective July 1, 2003. In the fiscal year ended June 30, 2004, the Health Fund reported those transactions necessary to wind down operations and allow the contractual run-off of claims on insurance contracts ended June 30, 2003. The net assets of the Health Fund as of June 30, 2003 were required to be transferred to the Trust Fund. Separate accounting records are maintained for the wind down of the Health Fund and the activities of the Trust Fund. As a result, the amounts reported for the Health Fund will be combined with the amounts reported for the Trust Fund to accurately present the statement of net assets and statement of revenues, expenses and changes in net assets of the Trust Fund as of and for the fiscal year ended June 30, 2004. On July 1, 2003, the net assets of the Health Fund which amounted to \$1,864,094 were transferred to the Trust Fund. The net assets transferred consisted of cash of \$25,945,978, premium receivables and reserves of \$2,171,639, net capital assets of \$2,018,028, premiums payable and reserves of \$25,003,838 and other liabilities of \$3,267,713.

The Trust Fund follows the financial reporting guidance for enterprise funds. As an enterprise fund, the financial reports of the Trust Fund include three statements. The statement of net assets summarizes the assets and liabilities and presents an overall picture of the financial position of the Trust Fund, the statement of revenue, expenses and changes in net assets summarizes the financial results of the operations for the fiscal year, and the statement of cash flows identifies the sources and uses of cash.

FINANCIAL HIGHLIGHTS

During the 2001 legislative session, the State Legislature enacted Act 147 to amend HRS Section 87-3, to allow the Health Fund to return insurance carrier refunds, rate credits and other earnings, as authorized by the Board of Trustees, to identifiable employees who participated in ascertainable years to create the refund or rate credit. As such, the Health Fund was given the authority to return a portion of the employees' health insurance premium contributions to those who were enrolled as active employees in the Health Fund's contracted plans.

During the year ended June 30, 2005, the remaining premium reserves and interest of \$6,400,917 related to Health Fund contracts were transferred to the Trust Fund. The Health Fund transferred \$7,145,000 to the Trust Fund during the year ended June 30, 2004. The Board of Trustees authorized amounts totaling \$5,228,011 related to the portion of the employees' health insurance premiums contributions to be returned to Health Fund employee-beneficiaries. The Trust Fund completed the Health Fund employee refund project in September 2005.

The Trust Fund has sent over a request to the Attorney General Office regarding the status of rate credits and reimbursements that the Trust Fund has received from the insurance carriers of the Health Fund. The advice is

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

June 30, 2005 and 2004

needed in order to determine whether those amounts can be used by the Trust Fund or must be distributed to the public employers.

The Trust Fund collected \$560,610,594 and \$28,739,161 in employer and employee contributions for health benefit plans and Medicare reimbursements, respectively and paid carriers \$555,144,562 and retirees \$28,739,161 in premiums and Medicare reimbursements, respectively for the year ended June 30, 2005. The Trust Fund collected \$490,942,661 and \$24,165,928 in employer and employee contributions for health benefit plans and Medicare reimbursements, respectively and paid carriers \$467,397,681 and retirees \$24,166,628 in premiums and Medicare reimbursements, respectively, for the year ended June 30, 2004. The monthly premiums for the Trust Fund's benefit plans include administrative fees that are intended to cover the Trust Fund's administrative expenses. The administrative fees collected from the employers were \$3,045,548 and \$3,547,052 for the years ended June 30, 2005 and June 30, 2004. The Trust Fund held \$5,438,650 and \$4,949,287 in reserves for carrier retrospective premiums as of June 30, 2005 and 2004, respectively. The increases are principally due to the increase in enrollments and health benefit insurance premiums.

The administrative expenses budgeted for the Trust Fund totaled approximately \$2,889,000 and \$3,439,250 for the years ended June 30, 2005 and 2004, respectively. Actual expenditures totaled approximately \$3,399,542 and \$3,263,279 excluding the loss from the payment methodology for the years ended June 30, 2005 and 2004, respectively. The expenses included \$1,236,787 and \$1,211,711 for personal services, \$443,469 and \$868,331 for consultant services, \$569,103 and \$554,175 for depreciation, \$391,443 and \$202,051 for computer system maintenance fees, \$129,501 and \$71,594 for public officials liability, fiduciary liability and fidelity bond insurance for trustees, and \$629,239 and \$355,417 for miscellaneous expenses such as open enrollment, office supplies, telephone, travel, copier rental and equipment for the years ended June 30, 2005 and 2004, respectively.

Since HRS Chapter 87A does not contain the same statutory requirements that were in Chapter 87 related to the refund of excess insurance reserves, the Trust Fund recognized the excess insurance reserves for the plan year ended June 30, 2005 and 2004 as revenues rather than premium reserves payable to employers and employees. As a result, total revenues received by the Trust Fund were \$13,448,808 and \$33,897,235 for the years ended June 30, 2005 and 2004, respectively. The decrease in total revenues is principally due to the amount of premium gains recognized during the years ended June 30, 2005 and 2004. During the year ended June 30, 2005, the Trust Fund recognized approximately \$8 million in premium gains from HMSA medical and prescription drug plans, Royal State National dual-coverage plans, Aetna life insurance plans and VSP vision plans compared to approximately \$28 million in premium gains from HMSA medical and prescription drug plans during the year ended June 30, 2004.

In addition, the Trust Fund exercised its option to extend its health benefits contracts which expired on June 30, 2005 for an additional two years through June 30, 2007.

The net asset values of capital assets were \$1,129,682 and \$1,463,853 at June 30, 2005 and 2004, respectively. Depreciation expense for the years ended June 30, 2005 and 2004, amounted to \$569,103 and \$554,175, respectively. Capital assets in the amount of \$2,018,028 were transferred from the Health Fund at its book value to the Trust Fund on July 1, 2003.

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

June 30, 2005 and 2004

The Trust Fund did not have substantial operating activities until July 1, 2003 when the Trust Fund replaced the Health Fund. As such, the summary financial results are presented as of and for the years ended June 30, 2005 and 2004 only.

A summary of operations and changes in net assets for the years ended June 30, 2005 and 2004 follows:

	2005	2004
Operating revenues	\$ 3,045,548	\$ 3,547,052
Non-operating revenues	10,403,260	30,350,183
Total revenues	13,448,808	33,897,235
Operating expenses and total expenses	4,831,374	4,203,732
Income before transfers	8,617,434	29,693,503
Transfers	128,424	1,843,174
INCREASE IN NET ASSETS	<u>\$ 8,745,858</u>	<u>\$31,536,677</u>

A summary of the Trust Fund's net assets is shown below:

	2005	2004
Current assets	\$98,046,898	\$89,039,860
Capital assets	1,129,682	1,463,853
Total assets	99,176,580	90,503,713
Current liabilities	57,732,471	57,828,457
Long-term liabilities	111,487	88,492
Total liabilities	57,843,958	57,916,949
Net assets		
Invested in capital assets	1,129,682	1,463,853
Unrestricted		
Undesignated	40,112,973	31,122,911
Board designated for Health Fund employee refund project	89,967	-
	<u>40,202,940</u>	<u>31,122,911</u>
Total net assets	41,332,622	32,586,764
Total liabilities and net assets	<u>\$99,176,580</u>	<u>\$90,503,713</u>

Hawaii Employer - Union Health Benefits Trust Fund
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STATEMENTS OF NET ASSETS - ENTERPRISE FUND

June 30,

ASSETS

	2005	2004
CURRENT ASSETS		
Cash (note B3)	\$76,933,614	\$44,351,277
Premiums receivable from individuals, net of allowance \$103,503 in 2005	116,194	16,804
Medicare reimbursements receivable from individuals	49,436	19,630
Premiums receivable from State of Hawaii and counties	13,050,749	11,580,805
Premiums reserves held by insurance companies (note D)	7,211,320	32,843,070
Receivable from insurance companies	385,432	-
Due from State of Hawaii and counties	67,044	-
Prepaid expenses	233,109	228,274
Total current assets	98,046,898	89,039,860
NONCURRENT ASSETS		
Capital assets, net of accumulated depreciation (notes B2 and C)	1,129,682	1,463,853
Total assets	\$99,176,580	\$90,503,713
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Vouchers and contracts payable	\$ 48,787	\$ 70,566
Accrued wages and employee benefits payable	96,179	77,771
Premium reserves payable to employers and employees related to Health Fund contracts (note D)	5,806,085	11,291,096
Retrospective premium payable (note D)	5,438,650	4,949,287
Premiums payable	46,302,333	41,375,994
Due to State of Hawaii and counties	-	1,559
Compensated absences, current portion (note B4)	40,437	62,184
Total current liabilities	57,732,471	57,828,457
NONCURRENT LIABILITIES		
Compensated absences (note B4)	111,487	88,492
Total liabilities	57,843,958	57,916,949
NET ASSETS		
Invested in capital assets	1,129,682	1,463,853
Unrestricted		
Undesignated	40,112,973	31,122,911
Board designated for Health Fund employee refund project	89,967	-
	40,202,940	31,122,911
Total net assets	41,332,622	32,586,764
Total liabilities and net assets	\$99,176,580	\$90,503,713

The accompanying notes are an integral part of this statement.

Hawaii Employer - Union Health Benefits Trust Fund
State of Hawaii

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS - ENTERPRISE FUND

Year ended June 30,

	2005	2004
Operating revenues		
Administrative fees (note I)	\$ 3,045,548	\$ 3,547,052
Total operating revenues	<u>3,045,548</u>	<u>3,547,052</u>
Operating expenses		
Loss from payment methodology (note J)	1,431,832	940,453
Personal services	1,236,787	1,211,711
Depreciation	569,103	554,175
Contracted services	443,469	868,331
Repairs and maintenance	391,925	212,697
Health Fund employee refund project	167,033	-
Printing and binding	137,247	141,477
Insurance	129,501	71,594
Provision for bad debt	103,503	-
Postage	48,304	55,024
Equipment	41,240	7,166
Transportation	37,009	17,052
Occupancy (note K)	32,260	-
Rental of equipment	17,047	14,152
Supplies	15,845	11,462
Training	11,140	6,102
Telephone	11,019	13,111
Dues and subscriptions	4,489	9,292
Public education	-	19,540
Other	2,621	50,393
Total operating expenses	<u>4,831,374</u>	<u>4,203,732</u>
Operating loss	(1,785,826)	(656,680)
Non-operating revenues		
Increase in premium reserves (note D)	8,399,900	27,392,459
Increase in premium reserves related to Health Fund contracts	266,820	2,200,000
Interest income and other	1,736,540	757,724
Total non-operating revenues	<u>10,403,260</u>	<u>30,350,183</u>
Income before transfers	8,617,434	29,693,503
Transfers		
Transfer from the Department of Budget and Finance	128,578	-
Transfer of net assets from the Health Fund	-	1,864,094
Transfer to other government agencies	(154)	(20,920)
	<u>128,424</u>	<u>1,843,174</u>
INCREASE IN NET ASSETS	8,745,858	31,536,677
Net assets at beginning of the year	<u>32,586,764</u>	<u>1,050,087</u>
Net assets at end of year	<u>\$41,332,622</u>	<u>\$32,586,764</u>

The accompanying notes are an integral part of this statement.

Hawaii Employer - Union Health Benefits Trust Fund
State of Hawaii

STATEMENTS OF CASH FLOWS - ENTERPRISE FUND

Year ended June 30,

	2005	2004
Cash flows from operating activities:		
Cash paid to vendors	\$ (1,343,114)	\$ (1,719,746)
Cash paid to employees	(1,253,943)	(1,242,355)
Cash received from State of Hawaii, counties and individuals for premiums and administrative fees	560,610,594	490,942,661
Cash paid for premiums	(555,144,562)	(467,397,681)
Cash returned to employers for premium overpayments related to Health Fund contracts	-	(4,100,246)
Cash received from insurance carriers and unions for premium overpayments	125,771	363,739
Refunds of premiums to individuals and unions	-	(85,736)
Cash received from State of Hawaii and counties for Medicare reimbursements	28,739,161	24,165,928
Cash paid to individuals for Medicare reimbursements	(28,739,161)	(24,166,628)
Reserves returned by insurance carriers	33,751,531	-
Refund of reserves and interest to employees related to Health Fund contracts	(5,328,179)	-
Transfer of vacation credits for Health Fund employees	128,578	-
Transfer of vacation credits to other governmental agency	(154)	-
Net cash provided by operating activities	31,546,522	16,759,936
Cash flows from investing activities:		
Interest received	1,275,397	448,503
Purchases of furniture and equipment	(239,582)	-
Net cash provided by investing activities	1,035,815	448,503
Cash flows from noncapital financing activities:		
Transfer of cash from Health Fund	-	25,945,978
Net cash provided by noncapital financing activities	-	25,945,978
NET INCREASE IN CASH	32,582,337	43,154,417
Cash at the beginning of year	44,351,277	1,196,860
Cash at end of year	<u>\$ 76,933,614</u>	<u>\$ 44,351,277</u>

The accompanying notes are an integral part of this statement.

Hawaii Employer - Union Health Benefits Trust Fund
State of Hawaii

STATEMENTS OF CASH FLOWS - ENTERPRISE FUND (continued)

Year ended June 30,

	<u>2005</u>	<u>2004</u>
Reconciliation of change in net assets to net cash provided by operating activities:		
Operating loss	\$ (1,785,826)	\$ (656,680)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation	569,103	554,175
Reserves provided by operating activities	9,260,937	549,683
Increase in Medicare reimbursements receivable from individuals	(29,806)	(19,630)
Increase in premiums receivable from State of Hawaii and counties	(1,469,944)	(11,580,805)
Decrease in premium reserves held by insurance companies	25,631,750	-
Decrease in premium reserves payable on behalf of Health Fund	(5,485,011)	-
Increase in receivable from insurance companies	(385,432)	-
Increase (decrease) in premiums receivable from individuals	(99,390)	30,516
Increase in prepaid expenses	(4,835)	(228,274)
(Decrease) increase in vouchers and contracts payable	(21,779)	24,569
Increase in accrued wages and employee benefits payable	18,408	(76,756)
Increase in premiums payable to carriers	5,415,702	31,224,465
Increase in compensated absences	1,248	15,310
Decrease in amounts due to State of Hawaii, counties and individuals	(68,603)	(3,076,637)
Net cash provided by operating activities	<u>\$ 31,546,522</u>	<u>\$ 16,759,936</u>

The accompanying notes are an integral part of this statement.

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

NOTES TO FINANCIAL STATEMENTS

June 30, 2005 and 2004

NOTE A – FINANCIAL REPORTING ENTITY

During the 2001 legislative session, the State Legislature enacted Act 88 to amend the Hawaii Revised Statutes (HRS) by adding Chapter 87A that established a new trust fund called the Hawaii Employer-Union Health Benefits Trust Fund (Trust Fund). The Trust Fund was established to design, provide and administer health and other benefit plans for State of Hawaii and County (Honolulu, Hawaii, Maui and Kauai) employees, retirees and their dependents beginning July 1, 2003. As a result, effective July 1, 2003 the Trust Fund replaced the Hawaii Public Employees Health Fund (Health Fund) and HRS Chapter 87 that established the Health Fund was repealed. The net assets of the Health Fund were transferred to the Trust Fund effective July 1, 2003. The net assets transferred consisted of cash and cash equivalents of \$25,845,978, premium receivables and reserves of \$2,171,639, net capital assets of \$2,018,028, premiums payable and reserves of \$25,003,838 and other liabilities of \$3,267,713.

The Trust Fund is administratively attached to the Department of Budget and Finance in the executive branch of the State. The Trust Fund's basic financial statements reflect only its portion of the fund type categories. The State Comptroller maintains the central accounts for all State funds and publishes annual financial statements for the State, which includes the Trust Fund's financial activities.

Under Chapter 87A, HRS, the Trust Fund is administered by a Board of Trustees (the "Board") composed of ten trustees appointed by the Governor of the State of Hawaii. The Board is responsible for determining the nature and scope of benefit plans offered by the Trust Fund, negotiating and entering into contracts with insurance carriers, establishing eligibility and management policies for the Trust Fund, and overseeing all Trust Fund activities. The Board relies on professional services provided by a salaried Administrator, the State Attorney General and a Benefit Plan Consultant.

The Trust Fund currently provides medical, prescription drug, dental, vision, chiropractic, dual-coverage medical and prescription, group life insurance and long-term care insurance benefits. The medical plans include a statewide service benefit plan and a federally-qualified HMO plan. Other benefit plans are offered on a statewide basis.

The employers' share of benefit plan contributions for collectively bargained employees are negotiated by the State and Counties with the exclusive representative of each employee bargaining unit. Employer contributions for all other employees not covered by collective bargaining contracts and for retirees are prescribed by the HRS. Any remaining premium balance is paid by employees through payroll deductions or Premium Conversion Plan reductions.

State and county contributions also include the employees' share made through payroll deductions, contributions for retired employees, and Medicare reimbursements made by the Trust Fund to eligible retired employees and their spouses for Medicare Part B insurance premiums withheld from their social security benefits.

As of June 30, 2005, the Trust Fund provided insurance coverage to approximately 188,700 individuals consisting of 64,900 active employees; 31,400 retirees; 45,600 spouse; 900 domestic partners; 37,300 dependents under the age of 19; 8,200 dependents between the ages of 19-23 who are full-time students; and 400 disabled dependents.

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Measurement Focus and Basis of Accounting

The accounting policies of the Trust Fund conform to accounting principles generally accepted in the United States of America as applicable to enterprise activities of governmental units as promulgated by the Governmental Accounting Standards Board (GASB). In accordance with GASB standards, the Trust Fund has elected not to apply the Financial Accounting Standards Board pronouncements on accounting and financial reporting that were issued after November 30, 1989.

An enterprise fund is used to account for the acquisition, operation and maintenance of government facilities and services that are entirely or predominantly supported by user charges. The Trust Fund operations are accounted for on the flow of economic resources measurement focus and the accrual basis of accounting is utilized. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Proprietary funds distinguish operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services or goods in connection with the proprietary fund's ongoing operations. Revenues and expenses not meeting this definition are reported as non-operating revenues and expenses. The principal operating revenues of the Trust Fund are administrative fees. Interest income from investments and increase in premium reserves are reported as non-operating income.

2. Capital Assets

The Trust Fund's capital assets consist of furniture and equipment with estimated useful lives greater than one year and with an acquisition cost greater than \$5,000. Purchased capital assets are valued at cost. Donated capital assets are recorded at their fair market value at the date of donation. Capital assets transferred from the Health Fund are valued at \$2,018,028. Depreciation expense is determined using the straight-line method over the assets' useful life of 7 years.

3. Cash

Cash represents amounts held in the State Treasury. The State Director of Finance is responsible for safekeeping of all monies paid into the State Treasury (cash pool). The Director of Finance may invest any monies of the State, which in the Director's judgment are in excess of the amounts necessary for meeting the immediate requirements of the State. Cash is pooled with funds from other State agencies and departments and deposited into approved financial institutions or participates in the State Treasury Investment Pool System. Cash accounts that participate in the investment pool accrue interest based on the average weighted cash balances of each account.

The State requires that the depository banks pledge, as collateral, government securities held in the name of the State for deposits not covered by federal deposit insurance.

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

3. Cash (continued)

Investments can be categorized to give an indication of the level of risk assumed by the Trust Fund. Category 1 includes investments that are insured or for repurchase agreements, collateralized by underlying securities that are so held. Category 2 includes uninsured and unregistered investments for which the securities are held by the broker-dealer in the Trust Fund's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker-dealer but not in the Trust Fund's name.

Since all of the Trust Fund's cash is included in the State cash pool, the category of risk is not determinable at the Trust Fund's level.

4. Compensated Absences

Employees hired on or before July 1, 2001 earn vacation at the rate of one and three-quarters working days for each month of service. Employees hired after July 1, 2001 earn vacation at rates ranging between 1 and 2 working days for each month of service, depending upon the employee's years of service and job classification. Effective July 1, 2004, all employees earn vacation at the rate of one and three-quarters working days for each month of service. Vacation days may be accumulated to a maximum of 90 days. Employees are entitled to receive cash payment for accumulated vacation upon termination. The accompanying financial statements present the cost of accumulated unpaid vacation as a liability. A reconciliation of changes in aggregate liabilities for accumulated vacation is as follows:

	2005	2004
Balance at beginning of year	\$150,676	\$ –
Additions	79,052	247,109
Reductions	(77,804)	(96,433)
Balance at end of year	151,924	150,676
Less current portion	40,437	62,184
	<u>\$111,487</u>	<u>\$ 88,492</u>

Employees hired on or before July 1, 2001 also earn sick leave credits at the rate of one and three-quarters working days for each month of service. Employees hired after July 1, 2001 earn sick leave credits at the rate of one and one-quarter or one and three-quarters working days for each month of service, depending upon the employee's years of service and job classification. Effective July 1, 2004, all employees earn sick leave credits at the rate of one and three-quarters working days for each month of service. Sick leave credits may be accumulated without limit. Sick leave can be taken only in the event of illness and is not convertible to pay upon termination of employment. Accordingly, no liability for unpaid sick leave credits is reported in the accompanying financial statements. However, a Trust Fund employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the Employees' Retirement System of the State of Hawaii. Accumulated sick leave as of June 30, 2005 and 2004 relating to the Trust Fund approximated \$587,000 and \$624,000, respectively.

Hawaii Employer – Union Health Benefits Trust Fund
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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

5. Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

6. Receivables

Receivables consists primarily of amounts due from employers and employees for health benefits premium contributions. The employee receivables are reported as net receivables and were based on management's estimate of amounts considered collectible. Management considered receivables outstanding for more than 60 days by employees who are no longer employed by State or Counties to be uncollectible. An allowance for employer receivables is not considered necessary based on past collection experience.

7. Risk Management

The Trust Fund is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; natural disasters; and injuries to employees. A liability for a claim for a risk of loss is established if information indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss is reasonably estimable.

8. Reclassifications

Certain reclassifications have been made to the 2004 financials statements to conform to the 2005 presentations.

NOTE C – CAPITAL ASSETS

Capital asset activity for the years ended June 30, 2005 and 2004 were as follows:

	Balance at July 1, 2004	Increases	Decreases	Balance at June 30, 2005
Capital assets being depreciated				
Office furniture and equipment	\$ 3,890,742	\$ 239,582	\$13,000	\$ 4,117,324
Less accumulated depreciation	(2,426,889)	(569,103)	(8,350)	(2,987,642)
Capital assets, net	<u>\$ 1,463,853</u>	<u>\$(329,521)</u>	<u>\$ 4,650</u>	<u>\$ 1,129,682</u>

Hawaii Employer – Union Health Benefits Trust Fund
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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE C – CAPITAL ASSETS (continued)

	Balance at July 1, 2003	Transfer from Health Fund	Increases	Decreases	Balance at June 30, 2004
Capital assets being depreciated					
Office furniture and equipment	\$ –	\$ 3,890,742	\$ –	\$ –	\$ 3,890,742
Less accumulated depreciation	(–)	(1,872,714)	(554,175)	(–)	(2,426,889)
Capital assets, net	<u>\$ –</u>	<u>\$ 2,018,028</u>	<u>\$(554,175)</u>	<u>\$ –</u>	<u>\$ 1,463,853</u>

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS

The Trust Fund's primary purpose, as mandated by HRS Section 87A, is to provide employee-beneficiaries and dependent-beneficiaries with a health benefits plan and a long-term care benefits plan. To effectuate that purpose, the Trust Fund requested proposals and awarded multi-year health and life insurance benefit contracts during the period July 1, 2003 and expiring through June 30, 2007.

All of the carriers use experience rating in determining the premium rates except for Kaiser Foundation Health Plan. The carriers perform a preliminary and final annual accounting for each plan year to determine the premium surplus or underwriting loss. If in a plan year the earned premium exceeds total charges (net incurred and paid claims plus retention and the incurred reserve), the premium surplus will be held in a rate stabilization reserve or, at the option of the Board, the entire difference will be refunded to the Trust Fund. If there is an underwriting loss in the first plan year, the loss will be offset against any premium surplus from the second plan year. If there is a premium surplus in the first plan year and an underwriting loss in the second plan year, the premium surplus will be offset against the underwriting loss, if the premium surplus was held in a rate stabilization reserve. Premium surpluses refunded to the Trust Fund are not available to offset underwriting losses in subsequent plan years. If the initial two-year term is extended, the current premium surplus held in a rate stabilization reserve or underwriting loss will roll forward and be used to offset future surpluses or losses.

In addition, the annual accounting for active employees and retirees will be maintained separately. As such, the premium surplus of one group cannot be used to offset the underwriting loss of another group. Upon expiration or termination of the contract, any premium surplus will be refunded to the Trust Fund and any underwriting losses will not be paid by the Trust Fund.

Hawaii Employer – Union Health Benefits Trust Fund
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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

Health Maintenance Organization

The Trust Fund entered into a contract with Kaiser Foundation Health Plan, Inc. (Kaiser) to provide active employees and retirees with health maintenance organization (HMO) benefits for the period July 1, 2003 through June 30, 2005 and subsequently exercised its option to extend the contracts for an additional two years through June 30, 2007. HMO's do not use experience rating for setting the premium rates. Accordingly, there is no premium surplus or underwriting loss.

Medical and Prescription Drug Benefits

The Trust Fund entered into a contract with the Hawaii Medical Service Association (HMSA) to provide active employees and retirees with medical and prescription drug benefits for the period July 1, 2003 through June 30, 2005, with an option to extend the contract for an additional two years at the sole option of the Board. In September 2004, the Trust Fund elected to extend the HMSA health insurance contract through June 30, 2007. For the period July 1, 2003 through June 30, 2007, the gains and losses of the medical and prescription drug plans will be combined in order to determine whether there was a premium surplus or net loss for the active employees and retirees. Any net premium surplus will be refunded to the Trust Fund and any net loss will not be paid to HMSA.

As part of the agreement to extend the contract, HMSA returned to the Trust Fund in October 2004 the premium surplus from the medical and prescription drug plans which amounted to \$5,765,475 and \$21,626,984, respectively, based on the preliminary accounting from the first plan year ended June 30, 2004. This amount was recognized as an increase in premium reserves on the statement of revenues, expenses and changes in net assets in 2004. In August 2005, HMSA returned to the Trust Fund the additional premium surplus from the medical and prescription drug plans which amounted to \$5,519,871 and \$1,467,823, respectively, based on the final accounting from the first plan year ended June 30, 2004. This amount has been recognized as an increase in premium reserves on the statement of revenues, expenses and changes in net assets in 2005. The total premium surplus returned from the first plan year ended June 30, 2004 which amounted to \$34,380,153 is not available to offset any underwriting losses in the subsequent plan years.

In addition, effective July 1, 2006, a two percent (2%) retrospective premium agreement with HMSA for both active employees and retirees will be executed. Under this agreement, the Trust Fund will pay HMSA ninety-eight percent (98%) of the premiums due each month. At the end of the plan year, if claims and retention exceed ninety-eight (98%) of the premiums due for the plan year, the Trust Fund will pay HMSA the amount of the excess up to the withheld two (2%) percent.

Hawaii Employer – Union Health Benefits Trust Fund
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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

Medical and Prescription Drug Benefits (continued)

During the year ended June 30, 2005, the Trust Fund had the following financial experience related to the medical plans provided by HMSA:

	Active employees	Retirees	Total
Estimated underwriting gain at June 30, 2004	\$ 3,782,301	\$ 1,983,174	\$ 5,765,475
Additional underwriting gain	<u>3,269,887</u>	<u>2,249,984</u>	<u>5,519,871</u>
Final underwriting gain for plan year ended June 30, 2004	7,052,188	4,233,158	11,285,346
Amounts refunded to the Trust Fund in 2005	<u>(3,782,301)</u>	<u>(1,983,174)</u>	<u>(5,765,475)</u>
Amounts held by insurance carrier at June 30, 2005 to be refunded to the Trust Fund	<u>\$ 3,269,887</u>	<u>\$ 2,249,984</u>	<u>\$ 5,519,871</u>
Estimated underwriting gain at June 30, 2005 for plan year ended June 30, 2005, subject to final accounting	<u>\$11,955,707</u>	<u>\$15,314,856</u>	<u>\$27,270,563</u>

During the year ended June 30, 2005, the Trust Fund had the following financial experience related to the prescription drug plans provided by HMSA:

	Active employees	Retirees	Total
Estimated underwriting gain at June 30, 2004	\$ 8,993,260	\$ 12,633,724	\$ 21,626,984
Additional underwriting gain	<u>829,578</u>	<u>638,245</u>	<u>1,467,823</u>
Final underwriting gain for plan year ended June 30, 2004	9,822,838	13,271,969	23,094,807
Amounts refunded to the Trust Fund in 2005	<u>(8,993,260)</u>	<u>(12,633,724)</u>	<u>(21,626,984)</u>
Amounts held by insurance carrier at June 30, 2005 to be refunded to the Trust Fund	<u>\$ 829,578</u>	<u>\$ 638,245</u>	<u>\$ 1,467,823</u>
Estimated underwriting gain at June 30, 2005 for plan year ended June 30, 2005, subject to final accounting	<u>\$ 9,063,429</u>	<u>\$ 12,772,427</u>	<u>\$ 21,835,856</u>

Hawaii Employer – Union Health Benefits Trust Fund
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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

Medical and Prescription Drug Benefits (continued)

During the year ended June 30, 2005, the Trust Fund had the following combined financial experience related to the medical and prescription drug plans provided by HMSA:

	Active employees	Retirees	Total
Estimated underwriting gain at June 30, 2004	\$ 12,775,561	\$ 14,616,898	\$ 27,392,459
Additional underwriting gain	4,099,465	2,888,229	6,987,694
Final underwriting gain for plan year ended June 30, 2004	16,875,026	17,505,127	34,380,153
Amounts refunded to the Trust Fund in 2005	(12,775,561)	(14,616,898)	(27,392,459)
Amounts held by insurance carrier at June 30, 2005 to be refunded to the Trust Fund	<u>\$ 4,099,465</u>	<u>\$ 2,888,229</u>	<u>\$ 6,987,694</u>
Estimated underwriting gain at June 30, 2005 for plan year ended June 30, 2005, subject to final accounting	<u>\$ 21,019,136</u>	<u>\$ 28,087,283</u>	<u>\$ 49,106,419</u>

HMSA also was the plan provider for the contracts with the Health Fund that ended June 30, 2003. The premium surplus related to the prior contracts which amounted to \$3,209,246 at June 30, 2004 was refunded to the Trust Fund in 2005.

Vision Care Benefits

The Trust Fund entered into a contract with Vision Service Plan (VSP) to provide vision care benefits for active employees and retirees for the period July 1, 2003 through June 30, 2005 and subsequently exercised its option to extend the contracts for an additional two years through June 30, 2007. The contract includes a five percent (5%) retrospective premium agreement for both active employees and retirees. Under this agreement, the Trust Fund will pay VSP ninety-five percent (95%) of the premiums due each month.

At the end of the plan year, if claims and retention exceed 95% of the premiums due for the plan year, the Trust Fund will pay VSP the amount of the excess up to the withheld 5%. Since VSP is still allowed to receive the retrospective premium if they experience losses for the plan year based on the final accounting, a payable to VSP was recorded. At June 30, 2005 and 2004, the payable to VSP for the various plan years are as follows:

	2005	2004
Plan year ended June 30, 2004	\$123,960	\$413,900
Plan year ended June 30, 2005	420,471	—
	<u>\$544,431</u>	<u>\$413,900</u>

Hawaii Employer – Union Health Benefits Trust Fund
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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

Vision Care Benefits (continued)

During the year ended June 30, 2005, the Trust Fund had the following financial experience related to the vision care plans provided by VSP:

	Active employees	Retirees	Total
Estimated underwriting loss at June 30, 2004, prior to retrospective premiums	\$(1,754,481)	\$(1,187,375)	\$(2,941,856)
Additional underwriting gain	2,009,738	1,019,637	3,029,375
Final underwriting gain (loss) for plan year ended June 30, 2004, prior to retrospective premiums	255,257	(167,738)	87,519
2004 retrospective premiums held by the Trust Fund at June 30, 2005 due to the insurance carrier	-	123,960	123,960
Final underwriting gain (loss) for plan year ended June 30, 2004	255,257	(43,778)	211,479
Estimated underwriting gain (loss) at June 30, 2005 for the plan year ended June 30, 2005, prior to retrospective premiums	340,770	(120,156)	220,614
2005 retrospective premiums held by the Trust Fund at June 30, 2005	293,062	127,409	420,471
Estimated underwriting gain at June 30, 2005 for the plan year ended June 30, 2005, subject to final accounting	\$ 633,832	\$ 7,253	\$ 641,085
Cumulative underwriting gain (loss) as of June 30, 2005	\$ 889,089	\$ (36,525)	\$ 852,564

VSP also was the plan provider for the contract with the Health Fund that ended June 30, 2003. The premium surplus related to the prior contract which amounted to \$1,915 at June 30, 2004 was refunded to the Trust Fund in 2005.

Life Insurance Benefits

The Trust Fund entered into a contract with Aetna Life Insurance Company (Aetna) to provide term life insurance benefits to all eligible active employees and retirees for the period July 1, 2003 through June 30, 2007. During the

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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

Life Insurance Benefits (continued)

year ended June 30, 2005, the Trust Fund had the following financial experience related to the group life insurance contract with Aetna:

	Active employees	Retirees	Total
Estimated underwriting gain (loss) at June 30, 2004	\$517,112	\$ (3,040)	\$ 514,072
Additional underwriting gain	242,925	95,781	338,706
Final underwriting gain for plan year ended June 30, 2004	760,037	92,741	852,778
Amounts refunded to the Trust Fund in 2005	(760,037)	(92,741)	(852,778)
	<u>\$ –</u>	<u>\$ –</u>	<u>\$ –</u>
Estimated underwriting gain at June 30, 2005 for plan year ended June 30, 2005, subject to final accounting	\$ 989,272	\$ 181,354	\$1,170,626
Amounts held by insurance carrier at June 30, 2005 to be refunded to the Trust Fund	(188,292)	(34,644)	(223,626)
Net underwriting gain as of June 30, 2005	<u>\$ 800,290</u>	<u>\$ 146,710</u>	<u>\$ 947,000</u>

Previously, the Health Fund contracted with Royal State Life Insurance Company, Ltd. (RSN) and Grand Pacific Life Insurance Company, Ltd. (GPLI) to provide term life insurance benefits to all eligible active employees and retirees. The premium surplus related to the RSN and GPLI contracts which amounted to \$875,930 and \$448,716, respectively, at June 30, 2004 was refunded to the Trust Fund in 2005.

Dental Benefits

The Trust Fund entered into a contract with Hawaii Dental Service (HDS) to provide dental benefits for active employees and retirees for the period July 1, 2003 through June 30, 2005 and subsequently exercised its option to extend the contract for an additional two years through June 30, 2007. The contract includes a ten percent (10%) retrospective premium agreement for both active employees and retirees. Under this agreement, the Trust Fund will pay HDS ninety percent (90%) of the premiums due each month. At the end of the plan year, if claims and retention exceed 90% of the premiums due for the plan year, the Trust Fund will pay HDS the amount of the excess up to the withheld ten 10%. As HDS experienced losses in excess of the 90%, a payable to HDS of \$4,894,219 and \$4,535,387 was recorded at June 30, 2005 and 2004, respectively.

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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

Dental Benefits (continued):

During the year ended June 30, 2005, the Trust Fund had the following financial experience related to the dental care plans provided by HDS:

	<u>Active employees</u>	<u>Retirees</u>	<u>Total</u>
Estimated underwriting loss at June 30, 2004, prior to retrospective premiums	\$(5,340,018)	\$(2,875,840)	\$(8,215,858)
Additional underwriting gain	153,526	316,468	469,994
Final underwriting loss for plan year ended June 30, 2004, prior to retrospective premiums	(5,186,492)	(2,559,372)	(7,745,864)
2004 retrospective premiums paid in 2005	3,117,388	1,417,999	4,535,387
Final underwriting loss for plan year ended June 30, 2004	(2,069,104)	(1,141,373)	(3,210,477)
Estimated underwriting loss at June 30, 2005 for plan year ended June 30, 2005 prior to retrospective premiums	(4,688,377)	(2,299,075)	(6,987,452)
2005 retrospective premiums held by the Trust Fund at June 30, 2005	3,350,632	1,543,587	4,894,219
Estimated underwriting loss at June 30, 2005 for plan year ended June 30, 2005, subject to final accounting	(1,337,745)	(755,488)	(2,093,233)
Cumulative underwriting loss as of June 30, 2005	<u>\$(3,406,849)</u>	<u>\$ (1,896,861)</u>	<u>\$(5,303,710)</u>

HDS was also the plan provider for the contract with the Health Fund that ended June 30, 2003. The premium surplus related to the prior contract amounted to \$1,855,289 at June 30, 2004 was refunded to the Trust Fund in 2005.

Chiropractic Benefits

The Trust Fund entered into a contract with Mutual Benefit Association of Hawaii (MBAH) to provide active employees with chiropractic benefits for the period July 1, 2003 through June 30, 2005 and subsequently exercised its option to extend the contracts for an additional two years through June 30, 2007. The contract for the additional term was changed from an experience rated contract to a non-experience rated contract. As experience rating is not used for setting the premium rates, accordingly, there will be no premium surplus or underwriting loss for the period July 1, 2005 through June 30, 2007.

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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

Chiropractic Benefits (continued)

During the year ended June 30, 2005, the Trust Fund had the following financial experience related to the chiropractic plans provided by MBAH:

Estimated and final underwriting loss at June 30, 2004	\$ (8,558)
Estimated and final underwriting loss at June 30, 2005	\$(21,790)

Dual-Coverage Medical and Prescription Benefits

The Trust Fund entered into a contract with Royal State National Insurance Company, Ltd. (RSN) to provide active employees with dual-coverage medical and prescription drug benefits for the period February 1, 2004 through June 30, 2005 and subsequently exercised its option to extend the contract for an additional two years through June 30, 2007. During the year ended June 30, 2005, the Trust Fund had the following financial experience related to the dual-coverage medical and prescription drug plans provided by RSN:

Estimated underwriting loss at June 30, 2004	\$ (43,361)
Additional underwriting gain	89,223
Final underwriting gain for plan year ended June 30, 2004	45,862
Amounts refunded to the Trust Fund in 2005	(45,862)
	<u>\$ –</u>
Estimated underwriting gain at June 30, 2005 for the plan year ended June 30, 2005, subject to final accounting	<u>\$159,282</u>

All Contracts

Following is a summary of the premium reserves available to offset underwriting losses in subsequent years held by insurance carriers as of June 30, 2005 and 2004:

	2005	2004
<u>For plan year ended June 30, 2005:</u>		
HMSA – Medical contract	\$27,270,563	\$ –
HMSA – Prescription drug contract	21,835,856	–
VSP – Vision contract	889,089	–
Aetna – Life insurance contract	947,000	–
RSN – Dual coverage contract	159,282	–
<u>For plan year ended June 30, 2004:</u>		
Aetna – Life insurance contract	–	514,072
	<u>\$ 51,101,790</u>	<u>\$ 514,072</u>

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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

All Contracts (continued)

Following is a summary of the premium reserves not available to offset underwriting losses in subsequent years held by insurance companies reflected as premium reserves held by insurance companies on the statement of net assets as of June 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
<u>For plan year ended June 30, 2005:</u>		
Aetna – Life insurance contract	\$ 223,626	\$ –
<u>For plan year ended June 30, 2004:</u>		
HMSA – Medical contract	5,519,871	5,765,475
HMSA – Prescription drug contract	1,467,823	21,626,984
For plan years ended June 30, 2003 or prior	<u>–</u>	<u>5,450,611</u>
	<u>\$7,211,320</u>	<u>\$32,843,070</u>

Following is a summary of retrospective premium payable as of June 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
<u>Plan year ended June 30, 2005:</u>		
VSP – Vision contract	\$ 420,471	\$ –
HDS – Dental contract	4,894,219	–
<u>Plan year ended June 30, 2004:</u>		
VSP – Vision contract	123,960	413,900
HDS – Dental contract	<u>–</u>	<u>4,535,387</u>
	<u>\$5,438,650</u>	<u>\$ 4,949,287</u>

Hawaii Employer – Union Health Benefits Trust Fund
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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE D – HEALTH AND LIFE INSURANCE BENEFIT CONTRACTS (continued)

All Contracts (continued)

Following is a summary of the increase in premium reserves reflected on the statement of revenues, expenses and changes in net assets for the years ended June 30, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
<u>For plan year ended June 30, 2005:</u>		
Aetna – Life insurance contract	\$ 223,626	\$ –
<u>For plan year ended June 30, 2004:</u>		
HMSA – Medical contract	5,519,871	5,765,475
HMSA – Prescription drug contract	1,467,823	21,626,984
Aetna – Life insurance contract	852,778	–
VSP – Vision contract	289,940	–
RSN – Dual coverage medical and prescription contract	45,862	–
	<u>\$8,399,900</u>	<u>\$27,392,459</u>

HRS Section 87A does not require the Trust Fund to return insurance carrier refunds, rate credits, interest income and other earnings in excess of funds used to stabilize health benefits plan or long-term care benefits plan costs to the State General Fund and the respective counties. In addition, HRS Section 87A does not require the Trust Fund to return insurance carrier refunds, rate credits and other earnings, as authorized by the Board, to identifiable employees who participated in ascertainable years that created the refund or credit. Accordingly, the Trust Fund recognizes the gains as increases in reserves and related receivable as premium reserves held by insurance companies. These return provisions were previously allowed for the Health Fund. Premiums payable to employers and employees related to Health Fund contracts for these returns amounted to \$5,806,085 and \$11,291,096 as of June 30, 2005 and 2004, respectively. The Trust Fund returned the employees' portion of the premium reserves related to Health Fund contracts of \$5,228,011 in 2005.

NOTE E – RETIREMENT BENEFITS

1. Employees' Retirement System

Plan Description

All eligible employees of the State are required by Chapter 88 of the Hawaii Revised Statutes to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits. The ERS issues a publicly available comprehensive annual financial report that includes

Hawaii Employer – Union Health Benefits Trust Fund
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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE E – RETIREMENT BENEFITS (continued)

1. Employees' Retirement System (continued)

Plan Description (continued)

financial statements and required supplementary information for ERS. That report may be obtained from them.

The ERS consists of a contributory plan and a noncontributory plan. Employees covered by Social Security on June 30, 1984 were given the option of joining the noncontributory plan or remaining in the contributory plan. All new employees hired after June 30, 1984, who are covered by Social Security, are generally required to join the noncontributory plan. Both plans provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the payment of salary in lieu of vacation, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after this date is based on the three highest paid years of service excluding the payment of salary in lieu of vacation. Vesting requirements for the contributory and noncontributory plans are five years and ten years, respectively. All contributions, benefits and eligibility requirements are governed by Chapter 88.

Funding Policy

Most covered employees of the contributory plan are required to contribute 7.8% of their salary. Police officers, firefighters, investigators of the department of the prosecuting attorney and the attorney general, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2% of their salary. The actuarial cost or funding method used to calculate the total employer contribution required is the entry age normal actuarial cost method. Under this method, the total employer contributions to the ERS is comprised of normal cost plus level annual payments required to amortize the unfunded actuarial accrued liability over the closed period ending June 30, 2029.

The employer contribution rates for June 30, 2005 and 2004 were 9.14% and 8.87%, respectively.

2. Post-Retirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the State, pursuant to HRS Chapter 87, provides certain health care and life insurance benefits to all qualified employees.

For employees hired before July 1, 1996, the State pays the entire monthly health care premium for employees retiring with ten or more years of credited service, and 50% of the monthly premium for employees retiring with fewer than ten years of credited service.

For employees hired after June 30, 1996, and who retire with fewer than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50% of the retired employees' monthly Medicare or non-Medicare premium. For employees hired after

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NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE E – RETIREMENT BENEFITS (continued)

2. Post-Retirement Health Care and Life Insurance Benefits (continued)

June 30, 1996, and who retire with at least 15 years but fewer than 25 years of service, the State pays 75% of the retired employees' monthly Medicare or non-Medicare premium; for those retiring with over 25 years of service, the State pays the entire health care premium.

For employees hired after June 30, 2001, and who retire with fewer than 10 years of service, the State makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the State pays 50% of the retired employees' monthly Medicare or non-Medicare premium based on the self plan. For employees hired after June 30, 2001, and who retire with at least 15 years but fewer than 25 years of service, the State pays 75% of the retired employees' monthly Medicare or non-Medicare premium based on the self plan; for those retiring with over 25 years of service, the State pays the entire health care premium based on the self plan.

For active employees, the employer's contributions are based upon negotiated collective bargaining agreements, and are funded by the State as accrued on a pay-as-you-go basis.

3. Cost of Retirement Benefits

The Trust Fund's special share of the pension and post-retirement benefits expense was approximately \$88,300 and \$68,800, respectively, for the year ended June 30, 2005 and \$81,400 and \$66,000, respectively, for the year ended June 30, 2004 and are included in the Trust Fund's financial statements.

NOTE F – COMMITMENTS AND CONTINGENCIES

1. Deferred Compensation

The State offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all State employees, permits employees to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

All plan assets are held in a trust fund to protect them from claims of general creditors. The State has no responsibility for loss due to the investment or failure of investment of funds and assets in the plan, but does have the duty of due care that would be required of an ordinary prudent investor. Accordingly, the assets and liabilities of the State's deferred compensation plan are not reported in the State's or Trust Fund's financial statements.

2. Litigation

On June 30, 2003, a class action lawsuit was brought against the Health Fund to recover rate credits and reimbursements refunded to the Health Fund by the insurance carriers who provided active employee health

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE F – COMMITMENTS AND CONTINGENCIES

2. Litigation (continued)

plans through the Health Fund. The plaintiffs contend that they are entitled to all rate credits and premium surpluses and that their employers should not have been allocated any portion of such surpluses.

Under Act 88, SLH 2001, some of these rate credits and reimbursements were transferred to the Trust Fund. The Trust Fund voluntarily decided to refund the employees' share of the Health Fund rate credits and reimbursements. On November 17, 2005, the Trust Fund filed a motion for summary judgment based on its completion of the Health Fund employee refund project. The plaintiffs have also filed a motion to dismiss the Trust Fund from this action without prejudice. The Trust Fund believes they will prevail in their motion for summary judgment.

A second lawsuit was also brought against certain trustees of the Trust Fund and the State to recover damages based on the difference between what they have been paying under the Trust Fund's two tier health plans and what they would have paid under three or four-tier health plans. The plaintiffs contend the Trust Fund's trustees breached their fiduciary duties by adopting a two-tier health plan structure. The plaintiffs claim that health plans with three or four-tier rate structures are fairer and more equitable to public employees who have a single dependent. The defendants were granted summary judgment in this action on February 15, 2005. The plaintiffs filed an appeal on March 17, 2005. The appeal was assigned to the Supreme Court of the State of Hawaii. The appeal has been fully briefed, however, it is not known when the appeal will be heard or decided. The Trust Fund and the State plan to vigorously defend its position.

3. Reserve for Encumbrances

The reserve for outstanding encumbrances as of June 30, 2005 and 2004 amounted to approximately \$420,000 and \$395,000, respectively.

NOTE G – RISK MANAGEMENT

The Trust Fund is exposed to various risks of loss related to torts; theft of, damage to, or destruction of assets; errors or omissions; and workers' compensation. The State generally retains the first \$250,000 per occurrence of property losses and the first \$3 million with respect to general liability claims. Losses in excess of those retention amounts are insured with commercial insurance carriers. The limit per occurrence for property losses is \$25 million (\$10 for earthquake, named hurricane, and flood) and the annual aggregate for general liability losses per occurrence is \$7 million. The State also has an insurance policy to cover medical malpractice risk in the amount of \$30 million per occurrence with no annual aggregate limit.

The State is generally self-insured for workers' compensation and automobile claims. The State's estimated reserve for losses and loss adjustment costs includes the accumulation of estimates for losses and claims reported prior to fiscal year end, estimates (based on projections of historical developments) of claims incurred but not reported, and estimates of costs for investigating and adjusting all incurred and unadjusted claims. Amounts reported are subject to the impact of future changes in economic and social conditions. The State believes that, given the inherent variability in any such estimates, the reserves are within a reasonable and acceptable range of adequacy. Reserves are continually monitored and reviewed, and as settlements are made and reserves adjusted, the

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE G – RISK MANAGEMENT (continued)

differences are reported in current operations. A liability for a claim is established if information indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss is reasonably estimable.

In accordance with HRS 87A-25, the Trust Fund obtained additional fiduciary liability insurance with an annual aggregate for losses of \$10 million and a fidelity bond to cover employee dishonesty with an annual aggregate for losses of \$1 million. In addition, the Trust Fund also obtained a public officials and employment practices insurance policy to cover any wrongful acts or employment practices violation in which the Trust Fund retains the first \$25,000 per occurrence and the annual aggregate for losses is \$3 million.

NOTE H – RELATED PARTY TRANSACTIONS

The State's contribution for medical, dental, life insurance, vision care, and prescription drug benefits is transferred to the Trust Fund from the State Department of Budget and Finance each month and is accounted for as a deduction of the receivable due from the State.

Previously, the Trust Fund's office space was leased and paid for by the State Department of Accounting and General Services for the use of the State Department of Budget and Finance. In December 2004, a lease agreement was entered into between the Hawaii Employees' Retirement System (Lessor) and the Department of Accounting and General Services (Lessee) for the use of the same space for the Trust Fund. For the period January 1, 2005 through June 30, 2005, sixty percent (60%) of the lease was paid for by the Department of Budget and Finance and the remaining forty percent (40%) was paid for by the Trust Fund. Effective July 1, 2005, the entire lease is being paid for by the Trust Fund (note K).

NOTE I – ADMINISTRATIVE FEES

Effective July 1, 2003, the activities of the Trust Fund were principally supported through administrative fees for services whereas the activities of the Health Fund were principally supported by appropriations made available by the State Legislature. The administrative fees are assessed each pay period and vary depending upon the type of bargaining agreements. For the years ended June 30, 2005 and 2004, administrative fees amounted to approximately \$3,046,000 and \$3,547,000, respectively.

NOTE J – CARRIER PAYMENT METHODOLOGY

Effective July 1, 2003, the Trust Fund changed to a new method of calculating the premiums paid to the carriers from its predecessor, the Health Fund. Under the Health Fund, the premiums paid to the carriers were calculated on a semi-monthly basis. As a result, the premiums paid to the carriers were equal to the premiums collected from the employers and employees as the employers and employees billing were also calculated on a semi-monthly basis.

Under the new method, the premiums paid to the carriers are calculated on a monthly basis by multiplying the total number of active employees and retirees enrolled in the various plans on the last day of the month by the premium rates set forth in the contract agreements. As a result, the Trust Fund recognizes a gain or loss between the total premiums actually collected from the employers and employees and the total premiums actually paid to the carriers. For the years ended June 30, 2005 and 2004, the Trust Fund recognized losses of approximately \$1,432,000 and \$940,000, respectively.

Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

NOTES TO FINANCIAL STATEMENTS (continued)

June 30, 2005 and 2004

NOTE K – LEASE COMMITMENT

The Trust Fund's office is located in the City Financial Tower. The office space was previously being leased and paid for by the State Department of Accounting and General Services for the use of the State Department of Budget and Finance. In December 2004, the State Department of Accounting and General Services (Lessee) entered into a new lease agreement with the Hawaii Employees' Retirement System (Lessor) for the same office space for the use of the Trust Fund. For the period January 1, 2005 through June 30, 2005, sixty (60%) percent of the lease was paid for by the Department of Budget and Finance and remaining forty percent (40%) of the lease was paid for by the Trust Fund. Effective July 1, 2005, the entire lease is being paid for by the Trust Fund. The lease commenced on January 1, 2005 and expires on November 30, 2009. The lease includes a renewal and escalation clause. In addition to minimum rent, the lease provides for the payment of common area maintenance charges.

At June 30, 2005, the minimum rental commitment under the noncancelable operating lease is as follows:

	<u>Amount</u>
Year ending June 30,	
2006	\$161,300
2007	161,300
2008	161,300
2009	161,300
2010	<u>67,200</u>
	<u>\$712,400</u>

The rent expense for the year ended June 30, 2005 was \$32,260.

PART II

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS

Report on Internal Control Over Financial Reporting and on
Compliance and Other Matters Based on an
Audit of Financial Statements Performed in
Accordance with *Government Auditing Standards*

Board of Trustees
Hawaii Employer – Union Health Benefits Trust Fund
State of Hawaii

We have audited the financial statements of the Hawaii Employer – Union Health Benefits Trust Fund of the State of Hawaii (Trust Fund), as of and for the years ended June 30, 2005 and 2004, and have issued our report thereon dated October 28, 2005. We conducted our audits in accordance with auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audits, we considered the Trust Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Accordingly, we express no such opinion. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Trust Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, including applicable provisions of the Hawaii Public Procurement Code (Chapter 103D of the Hawaii Revised Statutes) and procurement rules, directives and circulars, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audits, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. We noted certain matters that we reported to the Board of Trustees and management of the Trust Fund in a separate letter dated October 28, 2005.

This report is intended solely for the information and use of the State of Hawaii, Board of Trustees and the management of the Trust Fund and is not intended to be and should not be used by anyone other than these specified parties.



Honolulu, Hawaii
October 28, 2005

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